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TAGS: ECON EFIN EINV PGOV RP
SUBJECT: UPBEAT ECONOMIC NEWS BUT UNDERLYING PROBLEMS

REFS: A) Manila 4878
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¶1. Summary: The Philippines is ending 2006 with good economic news. Growth is exceeding expectations, inflation and domestic interest rates are declining, the peso is strong, the stock market is soaring, international reserves are at an all-time high, and the balance of payments shows a hefty surplus. Unfortunately, the long-term prognosis is not nearly as positive. The privatization of the power sector, legislatively mandated years ago, is far behind schedule. Infrastructure is crumbling and government investment in education has not been sufficient to give all children classrooms, let alone materials and qualified teachers. Necessary constitutional changes to liberalize the investment regime are not being discussed as part of the on-going debate over constitutional reform. And corruption continues to drain away many of the resources the GRP does devote to resolving these serious problems. End Summary.

Growth Rate Good; Inflation Easing

¶2. This year's economic results are impressive. Growth projections for 2006 are now 5.5%, spurred by a recovery in exports and resilience in agriculture despite inconsistent rainfall in some areas and a spate of damaging typhoons. The economy is anchored by the 15% increase in remittances from Overseas Filipino Workers' (OFW) this year and a booming business process outsourcing (BPO) sector. The International Monetary Fund and the World Bank recently upgraded their GDP growth forecast for 2007 from earlier projections of between 5.5% and 5.6% to between 5.7% and 5.8%. Stable food prices, a stronger local currency, moderating oil prices, and responsible monetary policy brought consumer price inflation down to 4.7% in November 2006, the lowest rate since mid-2004.

Highs for Stock Market and Forex Rate

¶3. The foreign exchange rate has risen steadily to a six-year high of 49.31 pesos to the dollar in December while the Philippine stock market index hit a nine-year high recently. Domestic Treasury bill rates, the benchmark for interest rates on loans, are at a four-year low. Another indication of optimism is that the premium the government must offer to borrow money -- the interest rate differential between comparable U.S. and Philippine government foreign bonds in the secondary market -- has been narrowing since ¶2003. In fact, the risk premium on bonds maturing between 2008 and 2025 has tightened significantly from more than 500 basis points at

the end of 2002 to between 50 and 220 basis points at the end of November 2006.

Fiscal Deficit Falls Fourth Straight Year

¶4. The government's budget deficit will shrink for the fourth consecutive year after peaking above 5% of GDP in 2002. The deficit is likely to end 2006 at barely 100 billion pesos, below 2% of GDP, following greater revenue generation from new tax measures. The amended value added tax (VAT) law will generate about $1.5 billion in additional revenue for the year. The tax-to-GDP ratio will increase to more than 14.5% this year from just 12.3% in 2004, about halfway to the government's goal and former high-water mark of 17%.

BOP Surplus Boosts International Reserves

¶5. The Philippines is poised to end 2006 with the highest balance of payments surplus in seven years -- about $3 billion. Although the total value of imports rose from the high price of oil, the country benefited from strong merchandise exports (up 16.4% as of October) and OFW remittances (up 16.6% as of October). Up by 12% thus far, the number of overseas workers has topped the 1 million mark. Higher tourism receipts and increased foreign direct investment also helped boost the balance of payments. As a result of the hefty surplus, the central bank's gross international reserves hit a record $23 billion, equivalent to 4.5 months of imports and double the country's short-term foreign debt.

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Public Sector Debt Ratios Improving

¶6. The government's success in reducing the fiscal deficit and the improved financial performance of state-owned companies has slowed the expansion of public sector debt. As a result, the ratio of public sector debt to GDP declined from nearly 118% in 2003 to below 90% this year. The government used its strong international reserves to retire about $1.8 billion in foreign debt in 2006 to eliminate future interest payments on those loans and to reduce potential risks from the two-thirds share of foreign debt in the public sector's loan portfolio. Taking advantage of the improved appetite for longer debt maturities, the government also swapped about $3 billion in domestic and foreign debt for longer-term loans.

Non-Performing Loans Declining

¶7. Commercial banking system non-performing loan and non-performing asset ratios continue to decline after reverting to single-digits in mid-2005. According to the central bank, the ratio of non-performing loans to total loans has tapered off to just 7.2% from a high of almost 19% in 2001. The ratio of non-performing assets (which includes loans and foreclosed properties) to total resources has declined to 7.5% after hitting a high of over 14% in ¶2001. Over the next two years, the central bank expects these ratios to fall closer to the 3% to 4% range they were in before the Asian economic crisis of 1997.

Better Outlook and IMF Exit

¶8. Moody's Investors Service improved its rating outlook on the Philippines from "negative" to "stable" in early November because of the country's fiscal progress. Moody's action followed similar moves by four other major credit rating agencies (Standard & Poors, Fitch, Japan Credit Rating Agency, and Rating & Investment

Information, Inc.) during the first half of 2006. According to BSP officials, the Philippine Government expects to exit from four decades of direct IMF oversight when the current post-program monitoring arrangement ends in April 2007.

But Long-Term Challenges Remain

¶9. Despite the recent good news, the country's long-term economic prognosis is shaky. For example, poverty remains a serious problem with almost 40% of the population (about 33.4 million Filipinos) living on less than $2 per day. Polls indicate that a larger percentage of Filipinos are having trouble making ends meet than in the past and a larger percentage are experiencing hunger. In addition, the country is not attracting sufficient amounts of foreign direct investment. The Philippines will receive less than $2 billion in foreign direct investment (FDI) in 2006. Although a significant increase from previous years, it is still small compared to total FDI flows to the region or compared to any reasonable assessment of potential.

¶10. By concentrating its efforts in the following four areas, the Philippine government could demonstrate its will and ability to overcome institutional hurdles and pave the way for reduced poverty and expanded FDI:

-- Stalled Privatization: The delay in selling government power plants threatens public sector finances and undermines the long-term supply of affordable and reliable electricity. Even after the recent sale of two hydropower plants, the GRP has off-loaded less than 5% of its power generating assets - well below the 70% required by law. Many of these plants are old, inefficient and heavily subsidized, keeping electricity prices among the highest in Asia. By privatizing these assets, the government could save money, attract investment in new and more efficient power plants, and encourage an open, competitive market.

-- Crumbling Infrastructure: Government austerity to control the budget deficit has constricted the funding needed to improve infrastructure. Corruption keeps those funds which are appropriated from making the difference they should. In a 2006 World Bank study, the Philippines ranked last among 61 countries in physical infrastructure and near the bottom in educational facilities,

science and technology, and health. President Arroyo has reiterated at recent public events her intention to boost spending on roads, ports, and airports and increase budgetary resources for schools and clinics, in part to raise the country's low competitiveness ratings (ref a).

-- Corruption: Corruption is a major deterrent to raising government revenue, delivering vital social services such as health and education, improving infrastructure, and attracting foreign investment. The Philippines ranked 121st among 163 countries in Transparency International's 2006 Corruption Perceptions Index. According to a recent academic study, the country loses $8 billion a year in hidden international transactions. Although the government's previous anti-corruption drives have not improved perceptions, efforts have been reinvigorated with the U.S. Millennium Challenge Account's Threshold Program which focuses on transparency in revenue generation and combating corruption.

-- Liberalizing Restrictions on FDI: The 1987 Constitution places limits on the ability of foreigners to own land and to participate in various sectors of the Philippine economy. Although there is widespread understanding in Philippine policy circles of the severe damage this does to the country's competitiveness as a destination for investment, revision to these provisions is not being discussed as part of ongoing wrangling over possible constitutional reform.

Comment

¶11. To sustain the current economic momentum, the government must maintain high quality spending and resist loosening its purse strings during the 2007 mid-term election campaign and the controversial initiatives to change the constitution. Over the long-term, the government must stick with its reform efforts so the Philippines can catch up with its regional neighbors in spurring investment, stimulating growth, creating jobs, and alleviating poverty.

KENNEY